

## **OFFICE OF MANAGEMENT AND BUDGET**

### **Office of Federal Procurement Policy**

#### **Cost Accounting Standards Board; Accounting for the Cost of Employee Stock Ownership Plans.**

**ACTION:** Notice.

**SUMMARY:** The Office of Federal Procurement Policy, Cost Accounting Standards Board, invites public comments concerning a Staff Discussion Paper on accounting for the cost of employee stock ownership plans (ESOP) under government contracts.

**DATES:** Comments must be in writing and must be received by November 14, 2000.

**ADDRESSES:** All comments should be addressed to Dr. Rein Abel, Director of Research, Cost Accounting Standards Board, Office of Federal Procurement Policy, 725 17th Street, NW, Room 9013, Washington, D.C. 20503. ATTN: CASB Docket No. 00-03. The submission of public comments in writing, via letter, is requested, as receipt of a readable data file via Internet e-mail cannot be assured. To facilitate the CAS Board's review of submitted comments, you may include with your written comments a three point five inch (3.5") computer diskette copy of your comments and denote the word processing format used.

**FOR FURTHER INFORMATION CONTACT:** Rein Abel, Director of Research, Cost Accounting Standards Board (telephone: 202-395-3254).

### **SUPPLEMENTARY INFORMATION**

#### **A. Regulatory Process**

The Cost Accounting Standards Board's rules, regulations and Standards are codified at 48 CFR Chapter 99. Section 26(g)(1) of the Office of Federal Procurement Policy Act, 41 U.S.C. § 422(g), requires that the Board, prior to the establishment of any new or revised Cost Accounting Standard, complete a prescribed rulemaking process. The process generally consists of the following four steps:

1. Consult with interested persons concerning the advantages, disadvantages and improvements anticipated in the pricing and administration of Government contracts as a result of the adoption of a proposed Standard.
2. Promulgate an Advance Notice of Proposed Rulemaking.
3. Promulgate a Notice of Proposed Rulemaking.

4. Promulgate a Final Rule.

This proposal is step one of the four-step process.

## **B. Background and Summary**

In response to the Cost Accounting Standards (CAS) Board's continuing research, a number of commenters have identified accounting for the cost of employee stock ownership plans under government contracts as an issue requiring Board consideration. The primary concern raised is the lack of guidance concerning this matter in applicable government contracting regulations, and the attempt by the contracting parties, in certain cases, to apply various provisions of the CAS to accounting for the costs of ESOPs, when such CAS provisions do not explicitly address or even mention ESOPs. More specifically, issues have arisen in which the accounting for the cost of ESOPs have caused substantial controversies.

This Staff Discussion Paper represents the results of research performed by the staff of the Cost Accounting Standards Board, and is issued by the Board in accordance with the requirements of 41 U.S.C. § 422(g)(1)(A). The statements contained herein do not necessarily represent the position of the Cost Accounting Standards Board.

## **C. Public Comments**

Interested persons are invited to participate by submitting data, views or arguments with respect to this Staff Discussion Paper. All comments must be in writing and submitted to the address indicated in the "Addresses" section.

**Nelson F. Gibbs**

*Executive Director, Cost Accounting Standards Board*

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### **COST ACCOUNTING STANDARDS BOARD STAFF DISCUSSION PAPER -- ISSUES RELATING TO EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)**

The Cost Accounting Standards (CAS) Board is examining the accounting issues related to the measurement, assignment and allocation of costs associated with Employee Stock Ownership Plans (ESOPs) to government contracts. This Staff Discussion Paper (SDP) is part of the Board's deliberative process that may lead to a pronouncement by the Board on this topic. The purpose of this SDP is to solicit comments on the relevant issues.

## **BACKGROUND**

The initial purpose of ESOPs was to encourage employee stock ownership of American industry. Such encouragement was contained in the Employee Retirement Income Security Act of 1974 (ERISA) and

corresponding changes to the Internal Revenue Code. Congress has also commented on ESOP regulations dealing with the allowability of such costs for Government contract costing purposes. Specifically, the National Defense Authorization Act for fiscal year 1998 (Pub. L. 105-85, § 844, Nov. 18, 1997) included a section expressing the “Sense of Congress” on certain aspects of ESOP cost allowability.

More recently, ESOPs have also been used for additional purposes. According to the Statement of Position (SOP) 93-6, issued by the American Institute of Certified Public Accountants (AICPA), these other purposes include the following:

- To fund a matching program for a sponsor’s 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits;

- To raise new capital or to create a marketplace for existing stock;

- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits;

- To be part of the financing package in leveraged buy-outs;

- To provide a tax-advantaged means for owners to terminate their ownership;

- To be part of a long-term program to restructure the equity section of a plan sponsor’s balance sheet; and

- To defend the company against hostile takeovers.

Although costs of ESOP sponsorship are not explicitly covered by CAS, guidance is included in Federal Acquisition Regulation (FAR), 31.205-6(j)(8), and referred to in the Defense Contract Audit Agency (DCAA) Contract Audit Manual (§ 7-2114). These references either state or imply that a distinction exists between so-called “pension” and “nonpension” ESOPs.

In general, the lack of a clear regulatory framework in this area has contributed to an environment in which a number of legal actions and other disputes have occurred between the Government and contractors. *See, e.g., Ralph Parsons Co.*, ASBCA 37931, 91-1 BCA 23648, *reconsideration denied* 91-2 BCA 23751; *Ball Corp.*, ASBCA 49118 (Apr. 3, 2000).

The CAS Board first considered the issue of accounting for ESOP costs at its May 1995 meeting, wherein it was decided to establish a case on this topic. At the Board’s December 1995 meeting, the matter was further discussed and consideration was given to issuing an “interpretation” on the topic. A draft interpretation was submitted by the staff to the Board at the Board’s February 1996 meeting. In the ensuing Board discussion, the applicability of either CAS 9904.412 or CAS 9904.415 was

identified as one of the major issues. Other issues discussed were the characterization of interest in leveraged ESOPs, and the valuation of shares that are released from the ESOP's suspense account and allocated to individual employee accounts. The Board determined that these issues were matters appropriate for the Board's consideration. The staff was instructed to continue with its research on this topic.

As part of its research, the staff has consulted with various Government offices and other interested parties who have had experience with ESOPs. At the December 1998 open CAS Board meeting, the Director of Defense Procurement again urged the CAS Board to address the issue of accounting for the costs of ESOPs.

## **DISCUSSION**

A discussion of the more prominent ESOP issues follows with questions on each subject. Commenters who believe that the questions contained herein do not adequately cover all pertinent aspects of the topic are encouraged to submit comments dealing with any additional issues.

There are two forms of ESOPs -- nonleveraged and leveraged. Contributions to a nonleveraged ESOP are generally allocated to individual participant accounts before the end of the sponsor's fiscal year. A leveraged ESOP uses borrowed funds to acquire shares in the sponsoring company which are then held by the ESOP in a suspense account for potentially extended periods, prior to their release to individual employee accounts. In a leveraged ESOP, some maintain that the employer's periodic contribution to the ESOP contains two elements -- the cost of employee compensation and the cost of interest on borrowed funds.

Even though CAS do not deal explicitly with the costs associated with ESOPs, the parties to some government contracts have applied the provisions in existing Standards to support their position with respect to ESOP treatment. While the arguments have varied, at least one assertion has been that if an ESOP can be regarded as a "pension" ESOP, then it falls under the provisions of CAS 9904.412, Composition and Measurement of Pension Cost. This makes it easier, so some believe, to assert that the total of a contractor's payment to the ESOP, including any interest element, should be regarded as employee compensation. Others have asserted that if an ESOP is classified as a "deferred compensation" ESOP then the appropriate Standard for application is CAS 9904.415, Accounting for the Cost of Deferred Compensation. In this case, some have asserted that the cost measurement should not include interest while others have asserted that it should include interest. Thus, different interpretations of the various provisions of CAS by the contracting parties have become an element in recent disputes concerning accounting for ESOP contributions.

The question as to whether interest costs attributable to leveraged ESOPs should be reimbursed by the Government is a procurement policy issue with broad ramifications. However, this issue is not within the purview of the CAS Board. As stated in the CAS Board's Statement of Objectives, Policies and Concepts (May 1992):

“While the Board has exclusive authority for establishing Standards governing the measurement, assignment and allocation of costs, it does not determine the allowability of categories or individual items of cost. Allowability is a procurement concept affecting contract price and in most cases is established in regulatory or contractual provisions.”

Although accounting for the costs of ESOPs is addressed in the FAR and in other guidance applicable to cost allowability issues in Government contracting, the topic has not been dealt with explicitly in any of the existing CAS Board Standards. Private sector accounting standard setters have addressed the topic for financial reporting purposes. The current Statement of Position (SOP) on the topic was issued by the AICPA in November 1993 as SOP 93-6. This SOP was issued after an extensive promulgation process that included the publication of an exposure draft which attracted a significant number of comments. The SOP provides guidance on both periodic compensation cost measurement and applicable disclosure. It states that compensation costs and interest on borrowed funds should be reported as separate items in financial statements.

SOP 93-6 further states that the fair value prevailing at the time when the shares are “committed to be released for allocation to participant accounts” should be used for charging employee compensation costs when that was the purpose for which the shares were released. The SOP similarly provides that the cost of shares acquired or transferred to ESOPs should be valued on the date they were acquired or transferred. Any difference in value between the acquisition date and the date when the shares are released to the employee accounts is recognized as an equity adjustment in the financial statements.

At this point it may be useful to restate the CAS Board’s position on pronouncements issued by other authoritative bodies established to issue guidance affecting accounting for financial and tax purposes. In its Statement of Objectives, Policies and Concepts (May 1992) the Board stated:

“The Board will continue taking those other pronouncements into account to the extent it can do so in accomplishing its objectives. However, the Board recognizes that the purposes of these pronouncements are not intended to meet the objectives of contract costing. Therefore the Board will retain and exercise full responsibility for meeting the objectives of contract costing.”

In the light of this statement the first question may be stated as follows:

1. Does GAAP (SOP 93-6) provide sufficient guidance for accounting for the costs of ESOPs for Government contract costing purposes? Please discuss the rationale of your answer to this question.

If the answer to question 1, above, is no, then the Board would like to receive comments as to whether one of the existing CAS does or could be expanded to provide adequate guidance.

As noted earlier, CAS have been applied to these issues by the various parties to the Government contracting process. As there has not been any direct reference to ESOPs in any of the Standards, a party applying CAS to ESOP accounting must first identify a Standard that would be applicable in a particular instance. In general, the choice has been between CAS 9904.412 and CAS 9904.415.

To develop criteria for distinguishing the circumstances in which either of these two Standards may be applicable, two different types of ESOPs have been identified. The first type embraces the so-called “pension ESOPs” which are distinguished principally by the characteristic that they offer their participants, benefits for life. All other ESOPs are referred to as “nonpension” or “deferred compensation ESOPs.” In practice, it appears that the provisions of CAS 9904.412 have been applied to the first group of ESOPs, while the provisions of CAS 9904.415 have been applied to the second group. This attempt to distinguish between pension and deferred compensation ESOPs seems to be a categorization that is currently found only in the field of Government contract cost accounting. In the broader context, when accounting for ESOPs is discussed, this particular categorization is not used. Therefore, the question arises as to whether this distinction between pension and deferred compensation ESOPs is an approach that should be included in any future CAS Board promulgation on this topic.

2. Do you believe that distinguishing between “pension” and “deferred compensation” ESOP type is useful in the Government contract costing environment and that this feature should be included in any future CAS Board promulgation on this topic? Please include the rationale for your answer to this question.
3. If you believe that a distinction between ESOP types is useful and should be included in any future CAS promulgation do you also believe that amendments, or an interpretation, to CAS 9904.412 and/or CAS 9904.415, is the appropriate action for the Board to take?

Another area where differing opinions exist, concerns the measurement date for determining the fair value of shares released to employee accounts. Some ESOPs hold shares of the sponsor company in a suspense account for the purpose of subsequent distribution to employees. It is likely that the fair value of these shares will change while the shares are held in the suspense account prior to being transferred to individual employee accounts. Accordingly, two different dates have been suggested as measurement dates for the purpose of determining the fair value of the shares released to individual employee accounts.

The FAR, at section 31.205-6(j)(8), stipulates that “. . . the value of the stock contribution shall be limited to the fair market value of the stock on the date that the title is effectively transferred to the trust.” The FAR provisions do not, however, address what valuation applies on the date when shares are actually released to employees for determining individual employee compensation costs. In other words, the FAR implies that the cost of the shares at the time of their acquisition by the ESOP should also be used as their fair value at the time of their release to individual employee accounts.

4. Do you believe that the fair value of the shares released by an ESOP to individual employee accounts should be established at the date when the title to these shares is transferred to the ESOP or should it be the date when the shares are committed to be released to employee accounts? If you would like to propose a different date or a modified version of the two dates referred to above, please explain.

The cost allocated to contracts may also be different depending on what is to be measured -- the cost to the company or the amount of compensation received by the employee. The compensation received by the employee is the fair value of the shares or other consideration received by the employee. The cost to the company may be measured differently depending on whether the cost is measured as (1) the fair value of the shares on the date the sponsor transfers the shares to the ESOP; (2) the fair value of the shares on the date the ESOP purchases the shares; (3) the amount of the sponsor's cash contribution to the ESOP; or (4) a combination of the above.

5. For contract costing purposes, should a distinction be made between measurement of the "cost to the company" or measurement of compensation "received by the employee?" Please explain. If a distinction should be made, please also comment on the method that should be used to measure this amount.

In certain circumstances when CAS 9904.415 has been applied to accounting for ESOPs, further disputes may occur. CAS 9904.415 identifies two different methods for determining the present value of future benefits depending upon the method of settling the deferred compensation obligation. CAS 9904.415-50(d) provides guidance for the calculation when the settlement "is to be paid in money," while CAS 9904.415-50(e) provides guidance when "the compensation is received by the employee in other than money." These two approaches, CAS 9904.415-50(d) and (e), generally produce different present values of the future benefit and hence, different cost for contract costing purposes.

6. Should the form of payment of ESOP benefits to the employee make a difference in measuring the cost allocable to Government contracts? If so, how should the cost be determined?